

Real Estate Tax Services News

Keeping you informed

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Release of „2021 Administrative Principles” on transfer pricing matters

In brief

On 14 July 2021, the German Federal Ministry of Finance published its position on transfer pricing principles (specifically the correction of income pursuant to section 1 of the External Tax Relations Act (*Außensteuergesetz*, or AStG) – the income adjustment clause) in its latest administrative principles regarding transfer pricing¹ (hereafter the „2021 Administrative Principles”).

The 2021 Administrative Principles (which are binding on the tax authorities, but not on the taxpayer) cover 44 pages, and replace a number of previously published administrative principles on transfer pricing matters, including those of 1983 and 2005.

Key points for the real estate sector

Whilst the 2021 Administrative Principles are comprehensive and deal with a number of issues, key points for real estate investors (particularly those with financing) are as follows:

Debt capital vs share capital

The principles outlined by the OECD in Chapter X² of its Transfer Pricing Guidelines determining the nature of an intra-group financing instrument as either debt or equity, should be considered. However, the 2021



¹ *Verwaltungsgrundsätze Verrechnungspreise – Grundsätze für die Korrektur von Einkünften gemäß § 1 AStG*; Circular of 14 July 2021, IV B 5 - S 1341/19/10017 :001 (only available in German)

² Transfer Pricing Guidance on Financial Transactions

Administrative Principles do not provide any guidance on how to make this determination. It therefore appears that OECD Chapter X would need to be referred to in such cases, as it lists a number of economically relevant factors that indicate whether a purported loan actually has the economic characteristics of a loan, such as fixed repayment dates and an obligation to pay interest. A functional and risk analysis should also be undertaken as part of determining the appropriate transfer pricing.

Economic necessity of financing

The 2021 Administrative Principles also state that the loan must be economically required and justifiable in order to meet the arm's-length principle, in that third parties would generally not borrow without a reasonable prospect of making a return to cover the costs of the loan. Further, the borrowed funds would be used for the benefit of the borrower and its business (and not merely invested in a cash pool or overnight deposit account).

For the real estate sector, challenges may arise in future tax audits in relation to whether the loans are economically necessary and what the expected profits are.

Collateralised loans

The 2021 Administrative Principles also deal with the issue of collateralisation. Whilst acknowledging that collateralisation is generally customary amongst third parties, the use of non-secured loans between related parties can nevertheless still be analysed using arm's-length principles, considering factors such as:

- whether liabilities are generally collateralised when dealing with third parties;
- whether providing collateral would be economically advantageous to the borrower, such as being able to achieve a lower interest rate;
- alternative options, ie, whether pledging certain assets in relation to a third-party loan would be of greater benefit (eg, in the form of an interest rate reduction) than the alternative to pledging the same assets in relation to a related party loan, where the borrower has only limited assets to pledge; and
- whether the borrower has sufficient assets to be pledged to remain solvent.

As several of these factors rely on an examination of transactions with third parties in order to determine appropriate transactions between related parties, in the event of unsecured loans being granted within the group, demonstrating compliance with the arm's-length principle in the absence of third party loans may be difficult.

The 2021 Administrative Principles also note that implicit group support should not be used as a substitute for an enforceable security. However, group support does have a bearing on the borrower's credit rating, depending on the importance of the borrower within the corporate group and the purpose of the loan.

Low-substance finance companies (FinCos)

In relation to group financing entities that neither have the ability to control the use of the borrower's funds, nor bear the risks associated with the borrower's investments, such entities should be entitled to a small mark-up on their directly attributable costs (eg, salaries). An example is provided whereby a FinCo receives funds and forwards these to another entity without controlling or assuming any of the related risks. In such cases, the 2021 Administrative Principles conclude that it is not at "arm's length" if the FinCo receives an interest rate above a risk-free return. This view may lead to significant pressure on FinCo financing structures, whereby in the past the focus was on the creditworthiness of the borrower.

Services

A section is also included on intra-group services, which broadly reiterates the principles already outlined in the OECD Transfer Pricing Guidelines, including "on call" services (ie, having a service provider on hand to ensure that the services are available when needed). According to the German Federal Ministry of Finance, the costs of such services are only deductible if independent parties would also be willing to pay for such services (taking into account the probability of needing the services, the advantage of having the services on demand, and the ability of the service recipient to obtain the services promptly from other sources). Such opinions broadly reflect those of the OECD.

Our view

These 2021 Administrative Principles address a number of key financing issues that are covered by the OECD Chapter X of 2020 and are now covered in German administrative guidance for the first time.

Further, the 2021 Administrative Principles appear to be more onerous than the OECD pronouncements, such as the need to demonstrate the economic necessity of the loan and limiting the return of certain FinCos for pass-through financing to a risk-free rate.

Whilst the administrative principles are not binding on taxpayers (only on the tax authorities), taxpayers should nevertheless be familiar with their content in order to anticipate how tax authorities will assess their cross-border dealings (particularly in the event of a tax audit). Taxpayers should review, risk assess and, if possible, improve documentation regarding their financing transactions against the background of the new 2021 Administrative Principles.

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